

Drop-in Article

“Paying Reasonable Compensation to the S Corporation Shareholder-Employee”

The IRS sends this reminder: An S Corporation must pay reasonable compensation (subject to employment taxes) to shareholder-employee(s) in return for the services that the employee provides to the corporation, before a non-wage distributions may be made to that shareholder-employee. This issue has been identified as an area of non-compliance and will receive greater scrutiny in the foreseeable future.

Unlike a partnership, flow-through income from an S corporation is *not* subject to self-employment tax (Revenue Ruling 59-221, 1959-1C.B. 22). In direct contrast, a partnership's flow-through ordinary income *is* generally subject to self-employment tax. On the surface, this appears to be a clear tax advantage of an S corporation vs. a partnership. However, in terms of “*shareholder-employees*” of an S corporation, the analysis does not end here.

If a shareholder-employee of an S corporation provides services to that S corporation, then reasonable compensation (subject to employment taxes) generally needs to be paid in return before any non-wage distributions may be made to that shareholder-employee. Several court cases support the authority of the IRS to reclassify other forms of payments made to the shareholder-employee as a wage expense. See *Joly v Comm.* 2000-1 USTC 50315 (6th Cir., 2000). In addition, several court cases have reinforced and clarified the IRS position as to the employee status of S corporation shareholders who perform services for the S corporation. See *Veterinary Surgical Consultants, PC v. Commissioner*, 117 T.C. 141 (2001) and *Joseph M. Grey Public Accountant, P.C. vs. Commissioner*, 119 T.C. No. 5, (Sept. 16, 2002).

Provided an S corporation shareholder is an employee and has received an actual distribution, the only remaining area of question is what amount is considered “reasonable” for that particular shareholder-employee. Whether the amount paid for the services provided constitute “reasonable compensation” is based upon all the relevant facts and circumstances.